Outsourcing Opportunities in ASEAN: Policy Paper

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Policy Paper



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Table of Contents

1 Introduction and Context

The Regional Report analyses the Association of Southeast Asian Nations' (ASEAN) relative competitiveness with regard to outsourcing of goods and services and the rise of global value chains (GVCs). Based on the analysis in the more comprehensive Regional Report, the main objective of this Policy Paper is to highlight the *key* recommended policy orientations post 2015. This implies that the scope of this Policy Paper covers summarised information contained in the Regional Executive Summary and recommendations in concluding Chapter 8 of the Regional Report, and therefore does not dig into the same level of depth.

The rest of the Policy Paper is structured as follows. Firstly, it defines the context and introduces some key definitions. Secondly, it presents a brief overview of services outsourcing trends in recent decades. Thirdly, it considers ASEAN competitiveness by analysing the new trade in value-added (TiVA) database, the constructed GVC Readiness Index, and modern global value chains. All together, this informs the final section of the Policy Paper, which analyses GVC related factors affecting ASEAN positioning and presents ASEAN-wide policy orientations post 2015.

1.1 Context

GVCs and outsourcing are not new phenomena, but rather they are contemporary terms to describe intensifying trends in international trade and investment. These trends include the rising importance of services, the increasing fragmentation of production into GVCs, and the overall rise in global competition. The costs of protectionist policies have never been higher, including the potential for economies to succumb to a "middle-income trap". Outsourcing competitiveness is a path out of any such trap.

"Outsourcing" involves commissioning tasks outside the firm, which add value by transforming goods or services, that could also be done, or used to be done, inside the firm, and are still needed as intermediate inputs in the overall production process. Outsourcing involves business-to-business (B2B) transactions, which are internal to the overall production process itself, rather than business to consumer transactions. A lead outsourcing firm might offshore a variety of tasks to firms in other countries, generally to small and medium-sized enterprises (SMEs) in developing countries where costs are lower. SMEs, which conduct such tasks, can then be described as "on-shoring" tasks from a foreign firm or, more commonly, seen as accessing, entering or participating in a GVC.[1]

This "fragmentation of production" into goods and services tasks has resulted in the creation of value chains with service activities such as transport, logistics, and communications providing much of the "glue" between its various production processes. The set of activities comprising the value chain now crosses borders, has become international, and is the manifestation of globalization.

International outsourcing is not new. Outsourcing has always been a characteristic of international trade and investment, allowing private enterprises to exploit comparative advantages of different national locations and to reap efficiency gains through specialisation in intermediate products.

[1] If the relevant countries share a border, this process is sometimes described as "near-shoring."

What is new is the pace of change. In recent decades, the term "globalisation" has been used to describe economic, social and other consequences of the rapid increase in the proportion of international transactions compared to domestic exchanges, with much of that growth coming through the outsourcing of tasks within GVCs. Globalisation in this context describes the progressive increase in recent decades in the exchange of knowledge, trade and capital around the world.

The increasing focus on international trade has been driven by waves of new technologies that sharply reduce the time and cost of moving goods, services, information, ideas and people across borders. It is now argued that humans live in a "flat world" (or "small planet") where in economic terms, time and space have shrunk. The benefits of being economically integrated have been established and the costs of protectionist policies have increased.

The following section highlights three misconceptions about international trade, investment and outsourcing. These are important to consider throughout the Paper as evidence unfolds to clarify these misconceptions.

1. The fieldwork interviews conducted in preparation for the Regional Report revealed that ASEAN officials are optimistic about the economic capabilities of the ASEAN Member States (AMS). Nevertheless, there is a public perception that ASEAN may be overwhelmed by the economic might of China and India. Proximity to these two economic giants is sometimes seen as more of a challenge than an opportunity. There is a perception shared by ASEAN countries that they need protection from cheap imports from China.

   This Study suggests that this impression is misguided. The strong economic performance of AMS in recent decades is directly related to the rise of China and India to middle-income status. The benefits of trade have been a win-win, and ASEAN countries have found numerous competitive niches in goods and services. AMS are well integrated into global value chains, and analysis of competitiveness indicators shows that ASEAN is a leading regional group in certain categories. ASEAN is competing; the challenge, however, is to maintain the momentum beyond middle-income status.

2. A second misconception concerns import protectionist policies. It is still argued that direct interventions to promote import substitution will save foreign exchange, create jobs, and enable self-reliance. Direct interventions are introducing protectionist measures (typically from international competitors) and subsidies (e.g. cheap credit, land, or electricity). Protectionism involves a cost, paid by either the government or consumers, and it is important to understand the dynamics of these costs. By actively promoting an import-substitution activity, resources such as labour, land, and capital are being directed into an economic activity in which the economy has little or no comparative advantage, at least at that point in time. If the activity is persistently inefficient, these resources will remain locked in so long as the protectionist measures and subsidies continue. This slows the dynamic process of moving resources constantly from lower to higher value-adding activities. Rather than moving up global value chains, protection-dependent import-substituting industries become trapped at a prescribed

level of inadequate productivity, at the expense of other potentially competitive industries: a self-imposed middle-income trap.

3. The net employment impact of outsourcing is a third misconception. Outsourcing typically involves moving jobs from one country to another or moving jobs within a country. This is increasing production efficiency by exploiting different costs and capabilities. As a result, given competitive markets, firms benefit from lower costs and consumers benefit from a lower price, but some of the jobs may indeed have "moved overseas". This is a problem for economies only if it causes long-term unemployment. In dynamic economies, employment levels are maintained by judicious macroeconomic policies, and people progressively move from lower-paying (lower productivity) to higher-paying employment. This is what moving up value chains involves. Competitive markets drive both the destruction and the creation of firms and jobs. Capital, however, is more adaptable than labour within this process, necessitating retraining policies and adjustment and social security measures.

2 Measuring Outsourcing and Global Value Chain Perception

2.1 Situation Analysis and Trends

Patterns of world trade and investment have witnessed remarkable transformations in the transition to the 21st century. The forces of globalization and the process of opening up to greater economic integration with the rest of the world, coupled with lower trade costs and the revolution in information and communications technology (ICT), technical and business process innovations and more widespread availability of highly skilled workforces, are everywhere driving major adjustments in cross-border firm behaviour, generally described as outsourcing. As the World Economic Forum has described it, GVCs "have become the world economy's backbone and central nervous system" (World Economic Forum, 2012).

The continued rapid growth of outsourced tasks, however, should not be taken for granted – particularly where they are based on the wage differentials of semi-skilled workers. There are limits to the global growth of such outsourcing, and the nature of jobs continues to change. As the outsourcing industry has developed, mass basic services are being replaced by more nuanced and targeted assignments. While opportunities continue to grow, the recent slowdown in China and three other factors are slowing outsourcing growth:

1. The global labour arbitrage wage gap is declining. American real wages have not risen much in recent decades, while those in China and India have caught up.
2. Industrial automation decreases the numbers of workers needed, and the relative importance of labour costs in overall costs.
3. There was a degree of "herd behaviour" in the wave of outsourcing since the 1990s, and now that the real costs and benefits are better understood, many firms find it less attractive.

Services outsourcing has grown particularly rapidly in recent decades. Traditionally, services providers were constrained by their inability to capture, store and possess the value of the intangible. There were few opportunities to create step-by-step pathways to market as services generally needed to be produced, delivered and consumed simultaneously, limiting their B2B and cross-border trade opportunities. But telecommunications reforms and the application of digital technology to a widening range of business services are now driving a rapid emergence of fragmentation of intermediate activities into GVCs in services. The process is happening so rapidly that services intermediates (generally described as knowledge-intensive business services) have become the fastest growing component of world trade, generating a shift in the composition of most countries' services exports, away from the traditional transport and travel sectors towards greater sophistication and complexity.

Becoming an 'emerging' country for services outsourcing requires a conscious policy effort, addressing largely within-border issues relating to services efficiency. Malaysia and The Philippines have done so, the latter focusing on specific zones to bypass wider inefficiency problems in the protected domestic economy.

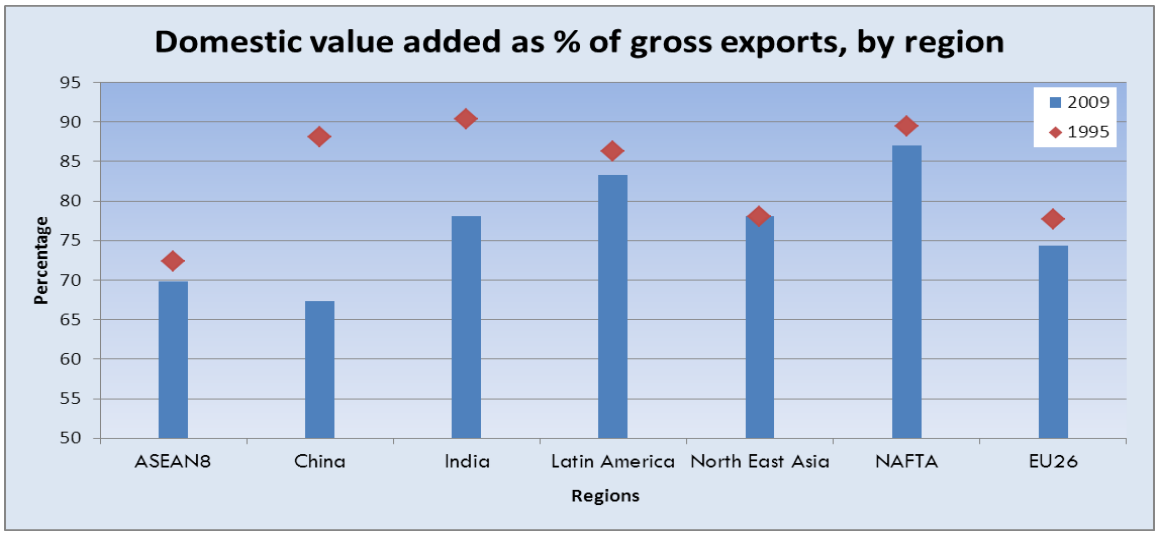
Services play an intrinsic role also in the orchestration and implementation of goods value chains. The traditional goods chain starts and ends with a series of pure services activities, from the original product idea, R&D and design, to final distribution to the customer and after sales service.

New OECD/WTO Trade in Value Added (TiVA) data released in 2013 has demonstrated the importance of outsourcing of intermediate production activities for both services and goods production.[2] TiVA data measures the extent of a country's participation in outsourcing activities by considering the value-add by each country in the production of goods and services consumed worldwide. This Study is among the first to specifically focus on the new data.

The central element in the new TiVA data is an estimated decomposition of gross exports into Domestic Value Added (DVA) and Foreign Value Added (FVA). When examining aggregate DVA shares of total exports for the eight AMS and various groups of global trading partners (including China, India, Latin America, North East Asia, NAFTA and the EU26) in 1995 and 2009, the data shows a general global decline in DVA shares in total exports for most country groupings, consistent with increasing integration into GVCs (see Figure 2.1 below).

[2] Indicators of TiVA are derived from national Input-Output Tables, which were integrated into a global system combining additional information on Bilateral Trade in goods by Industry and End-use (BTDIxE), International Trade in Services (TIS), and Structural Analysis (STAN) industry databases. These databases contribute to an improved understanding of the relation between trade and GDP, and of the economy-wide role of services by allowing us to measure services share in goods being exported.

Figure 2.1: Aggregate DVA shares of total gross exports for various trading groups[3]



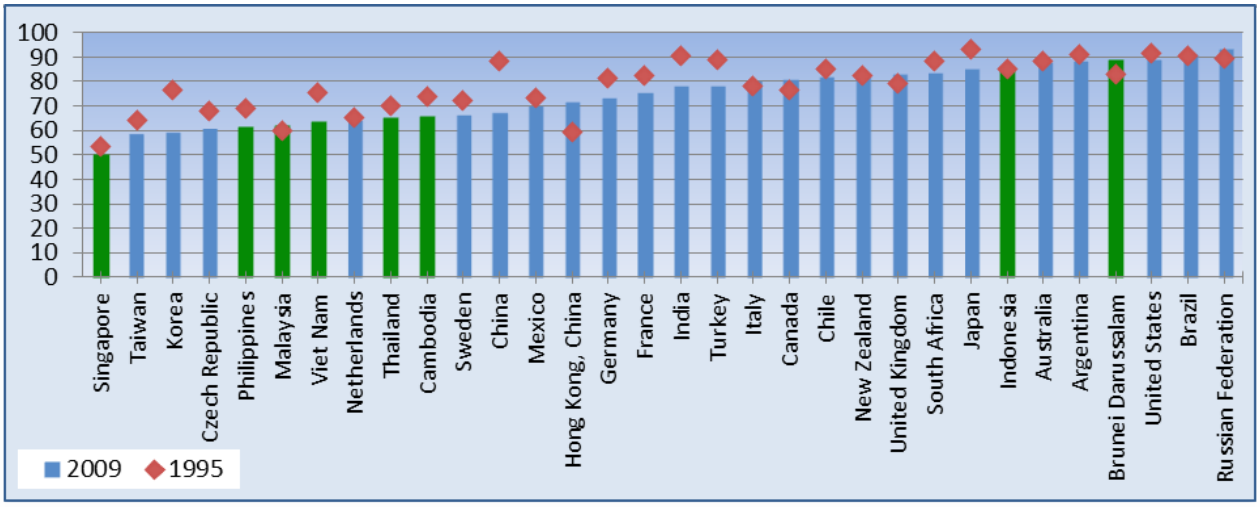
Source: OECD/WTO – Trade in Value Added data

This same period has witnessed a dramatic drop in the DVA share in China's exports (and also, but to a lesser extent, in India's). This reflects China's increasing integration into GVCs, fast becoming the stand-out "workshop of the world". Put another way: it reflects the emergence of both China and India as competitors with ASEAN as outsourcing destinations in the first decade of the 21st century.

Looking at the same data for individual countries (see Figure 2.2), Singaporean and Malaysian exports contained the least DVA content at just over 50% and 60% respectively in 1995 and that the last decade has seen only minimal continued downward shift in DVA content for these two economies. They were followed by Thailand and The Philippines, both with around 70% DVA content in their exports; but the last 15 years has seen a significantly smaller drop in DVA content for Thailand than for The Philippines. Vietnam and Cambodia have also moved in the GVC direction, with Vietnam experiencing the largest shift in this direction. In contrast, Indonesia and Brunei Darussalam have relatively high DVA content in their exports, essentially reflecting the importance of mining and natural resources in their overall export structure.

[3] Countries in each trading group include: ASEAN8 (Brunei Darussalam, Cambodia, Indonesia, Malaysia, The Philippines, Singapore, Thailand, Vietnam); India (India); China (China); Latin America (Argentina, Chile, Brazil); Developed Asian Countries (Chinese Taipei, Japan, South Korea); NAFTA (Canada, Mexico, United States); EU26 (Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxemburg, Malta, Netherlands, Poland, Portugal, Romania, Slovenia, Spain, Sweden).

Figure 2.2: Selected countries domestic value added as a percentage of gross exports



Source: OECD/WTO – Trade in Value Added data

When further broken down at the industry level, the TiVA data shows only 60% of China's gross exports of electronics are composed of domestic value-added. Meanwhile, over 70% of all China's imports of electronic components end up in exports. Examples from the ASEAN Member States include Cambodia, where the TiVA data reveals that 36% of domestic value from exports comes from low-value agricultural work, while garments contribute only 10% of domestic value-added (DVA). The TiVA data for Indonesia suggests that Indonesia is well connected to GVC's in the electronics industry. In fact, just under 30% of the value of gross exports in the electronics industry is made up of foreign value-added, indicating that Indonesia is involved in processing activities.

The TiVA data enables measurement of GVC participation rates, which is the percentage of a country's exports that are part of a GVC. The data identifies two components within exports, namely backward and forward linkages.[4] When considering issues related to climbing the value-added ladder, this information becomes invaluable. The TiVA data reveals that Indonesia's participation in GVCs for example is relatively low and is mainly driven by forward linkages. The high degree of forwards participation reflects the country's large exports of natural resources and raw materials, which are used as intermediate inputs in a range of GVCs, but have little FVA content in them prior to their initial export. Brunei Darussalam is in a similar situation.

The Regional Report reveals that the results of the analysis undertaken using the new TiVA data sets are powerful, and transformative of traditional trade and investment policy thinking. The results are summarized in the following six key global findings:

[4] Backward linkages refer to cases where a country's exports contain value-added content that was previously imported from elsewhere. Forward linkages refer to cases where exports are destined to be re-exported onwards following further value-adding by the immediate country.

1. **Trade in intermediates is more important than trade in final products**

   The TiVA data reveals the increasing dominance of trade in intermediates and the associated increase in global interdependence. Trade in intermediates represents over half of OECD countries' imports and close to three-fourths of the imports of large developing economies, such as China and Brazil (Ali and Dadush, 2011).

2. **Services share of world exports doubles to 45%**

   According to TiVA data, services represent nearly half of world exports when measured in value added terms. For the ASEAN 8, services represent only 34% of gross exports, which is well below the global average. Indeed, ASEAN export performance on services, like that of China, is contributing to dragging the entire APEC average down to 38%, also significantly below the global average. Moreover, worryingly given the high value-added nature of service activities, the average services share for the ASEAN 8 exports has fallen since 1995, going against the upward global trend. It is important to note that there are significant differences among individual AMS, and between country groupings.

3. **Imports, especially of services, generate export growth**

   There is a positive correlation between FVA and levels of manufactured exports. This is true for both good imports and services imports but even stronger in the case of services. This strong positive correlation supports the importance of minimizing restrictions on imports, in the interests of improved export performance.

4. **Bilateral trade imbalances are resized**

   TiVA data significantly readjusts the picture on countries' bilateral trade data. Examining the bilateral trade imbalance between a variety of countries and China, and comparing the size of the surplus/deficit as measured with gross trade statistics and value-added trade data is informative. For example, Vietnam's trade deficit with China is roughly halved, when the value of non-Chinese content in China's exports to Vietnam is considered. For any two countries, the greater the distance between them, as measured in production stages along the value chain, the more likely it is that gross trade statistics will overestimate the imbalance in their bilateral trade relationship.

5. **New competitiveness strengths and weaknesses are revealed**

   The TiVA data measures shifts in countries' revealed comparative advantage. It is now very clear that a country's competitiveness in any industry depends: (1) on the competitiveness of other domestic sectors; and (2) on inputs imported into the country. While Japan, Korea and Chinese Taipei all register improvements in revealed comparative advantage over the period 1995 to 2009, Indonesia for example experiences no overall shift in position.

6. **FDI enhances GVC participation**

   There is a positive correlation between levels of inward FDI and GVC participation. UNCTAD data provides evidence that participating in GVCs generally requires investment regimes that allow lead foreign firms to establish in-country. Similarly, TiVA data provides information on the role played by foreign affiliates in generating total exports. In the case of Ireland, for example, TiVA data reveals that in 2009 as much as 50% of export value-added was generated by foreign-owned firms.

3 GVC Readiness Index

To supplement the previous analysis of the TiVA data, this Study has also constructed a new and informative statistical database, the "GVC Readiness Index"[5], which is built from over 150 indicators into an equally weighted summation of eight groups: *human capital, innovation and R&D, digital infrastructure, physical infrastructure, quality of supporting institutions, domestic regulations, ease of trade, and relative cost competitiveness*, all of which are identified in the literature as key elements in determining competitiveness in a world trade environment dominated by outsourcing and GVCs[6].

Table 3.1 presents the basic results of the GVC Readiness Index for the AMS. It can be seen that the GVC Index is positively correlated to the World Bank Doing Business Index. The "Frontier" is a perfect score on every indicator, which would produce a summary result of "1.0". Singapore gets closest of all 144 countries in our database, scoring 0.73. Myanmar comes last, with the other eight AMS spread fairly evenly from rank 22 to 101. Of the remaining eight AMS, six score relatively higher in the GVC Readiness Index than in the Doing Business Index.

Table 3.1: ASEAN country rankings across three main indexes

Country name	**GVC Readiness Index** Distance to Frontier	ASEAN Ranking	World Ranking/144 countries	**WEF GCI (2014-2015) Ranking/144 countries**	**WB 2015 DB Ranking/189 countries**
Singapore	0.73	1	1	2	1
Malaysia	0.55	2	22	20	18
Brunei	0.50	3	33	N/A	101
Indonesia	0.47	4	41	34	114
Philippines	0.43	5	54	52	95
Vietnam	0.42	6	60	68	78
Thailand	0.42	7	62	31	26
Cambodia	0.35	8	90	95	135
Laos	0.32	9	101	93	148
Myanmar	0.10	10	144	134	177

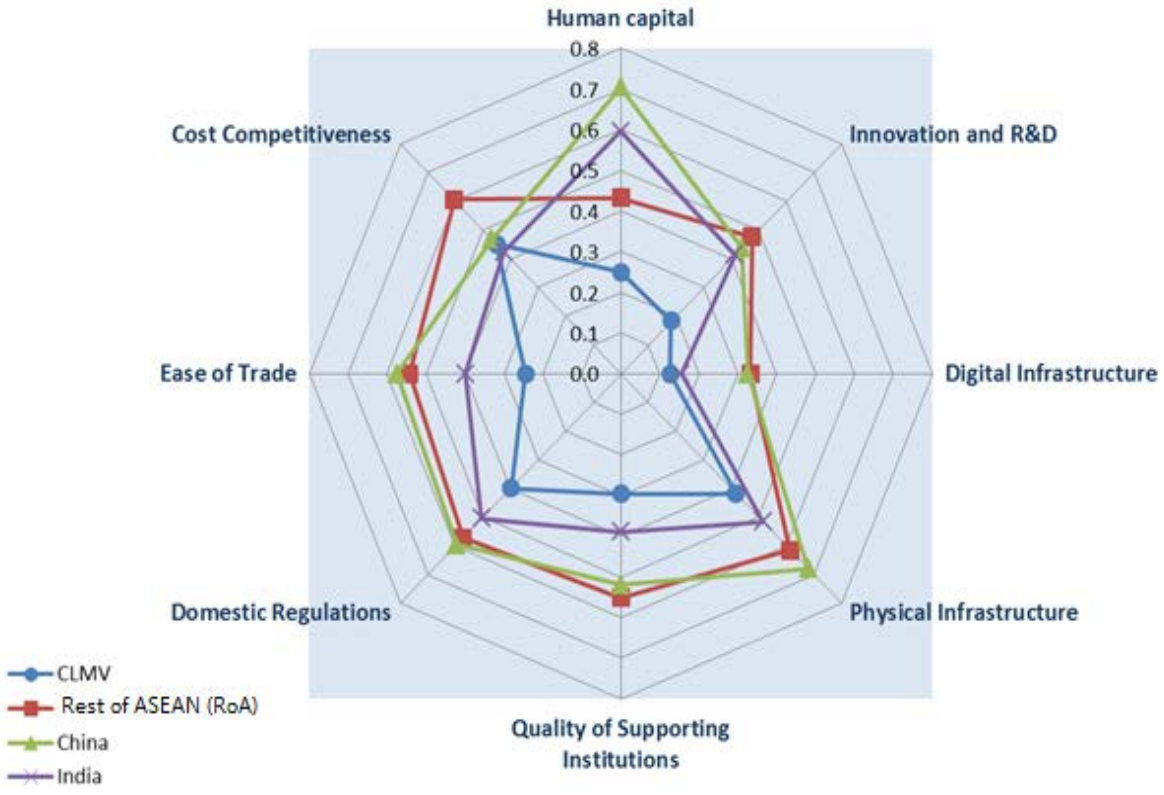
Data source: World Economic Forum – Global Competitiveness Index 2014-2015; World Bank – Doing Business Survey (2015) GVC Readiness Index (see Appendix 2 in ASEC Regional Report)

[5] More detailed information on the composition and construction of the GVC Readiness Index is explained in Appendix 1 of the Regional Report.

[6] The Index draws heavily on the World Bank Doing Business Survey, and the WEF Global Competitiveness Index, as well as using indicators from six other sources. Certain variables, however, are heavily weighted as most relevant to outsourcing. *Digital infrastructure* and *language skills* are weighted highly, for example, as is *human capital* in general.

Figure 3.1 compares the eight sub-indexes of the GVC Readiness Index across two ASEAN sub-groups (CLMV and ASEAN-6[7]) with China and India. The CLMV sub-group performs poorly in all but the *cost competitiveness* indicator. When comparing the remaining six AMS to China and India, strengths and weaknesses are seen. ASEAN-6 or "Rest of ASEAN" (RoA) is more *cost competitive* than China, and about the same in terms of *digital infrastructure*, *innovation, and supporting institutions*. The relative weaknesses are in *human capital* (due to the size of China's labour force), *physical infrastructure, domestic regulations, and ease of trade*. That RoA lags behind China in *domestic regulations* and *ease of trade* is a concern, and should be priorities for government-led reform to 2020.

Figure 3.1: ASEAN GVC Readiness compared to China and India



Data Source: GVC Readiness Index

The RoA also looks very competitive in terms of GVC readiness compared to India. India scores very low on *digital Infrastructure*. This data reveals the dualistic nature of the Indian economy: large areas of underdevelopment amidst pockets of modernity. The literacy rate in India in 2011 was only 74% (compared to over 90% for all AMS, except Cambodia and Lao PDR). The competitive Indian services outsourcing industry is centred on a small cluster of areas, where infrastructure and other variables (e.g. a skilled literate workforce) are much stronger than the nationwide averages.

[7] CLMV is the group of AMS that includes Cambodia, Myanmar, Lao PDR, and Vietnam. ASEAN-6 is referred to as "Rest of ASEAN" and includes Singapore, Malaysia, Brunei Darussalam, Indonesia, Thailand and The Philippines.

3.1 AMS Strengths and Weaknesses

There is difficulty analysing ASEAN as a group of ten countries given their economic diversity. Averages hide important country-specific exceptions. It is therefore important to consider these same indicators as they are measured across each AMS. Table 3.2 presents the strengths and weaknesses of each AMS (rather than each trade grouping) and highlights differences within the RoA and CLMV groups.

Table 3.2: Revealed AMS strengths and weaknesses

	Strengths	Weaknesses
Myanmar	Total labor force	Quality of transport Infrastructure; Soundness of banks; Ethical behavior of firms; Prevalence of foreign ownership
Lao PDR	Soundness of banks; Public trust in politicians;	Percentage of Individuals using the Internet; Tertiary education enrollment; Quality of transport Infrastructure
Cambodia	Complexity of tariffs; Services Trade Restrictiveness; Margin of preference in destination markets	Research and development expenditure (% of GDP); Percentage of Individuals using the Internet; Tertiary education enrollment; Quality of transport Infrastructure
Vietnam	Business-to-business internet use; Percentage of Individuals using the Internet; No. days to start a business	Quality of Management Schools; Research and development expenditure (% of GDP); Strength of auditing and reporting standards; PC Software piracy rate
Indonesia	Total Labor force; Complexity of tariffs; Tariff rate	Percentage of Individuals using the Internet; PC Software piracy rate; Port Infrastructure; Research and development expenditure (% of GDP); Int'l Internet bandwidth
The Philippines	Quality of management schools; Quality of transport Infrastructure; Soundness of banks; Strength of auditing and reporting standards; Complexity of tariffs	Research and development expenditure (% of GDP); Secure Internet servers (per 1 million people); Irregular payments in exports and imports; Public trust in politicians
Thailand	Soundness of banks; Prevalence of foreign ownership; Quality of transport Infrastructure	Public trust in politicians; Services Trade Restrictiveness; Complexity of tariffs
Malaysia	Prevalence of foreign ownership Availability of latest technologies; Firm-level technology absorption	Total Labor force; Margin of preference in destination markets; Complexity of tariffs
Brunei	Openness to multilateral trade rules; Margin of preference in destination markets	Quality of transport Infrastructure; Ethical behavior of firms
Singapore	Quality of transport Infrastructure; Soundness of banks; Quality of management schools; Availability of latest technologies; Ethical behavior of firms	Total Labor force; Margin of preference in destination markets

Singapore, Brunei Darussalam, and Malaysia have relatively few weaknesses and score highly across many indicators, while Myanmar, as the worst performer in the entire index, has few perceived strengths. The only indicator for which Myanmar scores slightly better out of the 65 selected indicators

is *public trust in politician*s, which is higher than The Philippines and Thailand and about the same as Cambodia, Vietnam and Indonesia.

In general, the weakest areas for the CLMV sub-group are intangible assets (*human capital, innovation and R&D, and digital infrastructure*). CLMV perform slightly better in *physical infrastructure* but still have poor quality *domestic transport infrastructure* comparing to the RoA. These two aspects together are a deterent to positive outsourcing decisions by foreigners.

The diversity of ASEAN economies inevitably creates challenges for economic integration, and for making ASEAN more competitive as a trading bloc. Each of the AMS has its own unique domestic circumstances and challenges, and its own economic and social development goals. ASEAN economies are distributed along a wide development spectrum. Nevertheless, ASEAN as a whole performs better than India and China accross a variety of GVC Readiness indicators. The RoA group in particular are much more globally competitive and well integrated into GVCs.

The analysis of the GVC Readiness Index leads to the following important conclusions:

1. There are vast differences between the CLMV and the ASEAN-6 group, and when combined into one ASEAN-wide number it typically appears that ASEAN has many weaknesses. Looking only at the ASEAN-6 group, the weaknesses mostly fade away, yet there is still great the diversity within the ASEAN-6 group.

2. The ASEAN-6 group is very competitive with China and India. Of the 65 indicators, ASEAN as a whole scores higher than India and China in more than half of the indicators, and lower than both countries in just 13. The ASEAN-6 also score higher than the Latin American group in two-thirds of the indicators. When compared to more developed regional groups, such as the EU26 and North East Asia (including Japan, South Korea, Hong Kong and Taiwan), ASEAN lags behind in the majority of the 65 specific indicators. ASEAN scored higher in a few indicators, for instance *high technology exports,* but mainly thanks to Singapore's performance.

3. The weakest areas for the ASEAN-6 group include *tertiary education, R&D, transport infrastructure, and harmonisation with global markets*. Although the ASEAN-6 average achieve higher scores than China and India in *tertiary education enrolment*, they rank on average well below the richest three trade groupings (EU, NAFTA, NE Asia). Stronger *human capital* is the most important variable to ensure value chain advancement and avoiding the middle-income trap. *R&D* as a percentage of GDP was markedly low for all AMS, despite a high percentage of high-technology manufacturing exports, suggesting that the movement from assembly to innovation is incomplete. The *quality of transport infrastructure* was one measure where China has evidently advanced ahead of ASEAN in general.

4. The North-East Asia group of countries (Japan, South Korea, Hong Kong, and Taiwan) is a good benchmark target group for ASEAN. This group scores highest on more indicators than any other group. Being in the same region, ASEAN should be looking north to the example of these countries across many indicators. Although some indicators will require long term large investments to improve, many are system changes that can be achieved quickly, given political will.

5. The CLMV group score is considerably weak across almost all indicators. Vietnam is the most competitive of the four and it has growing commonalities with members of the ASEAN-6 group. Nevertheless, as a group, CLMV are clearly very different economies to countries like Singapore and Malaysia. They are viewed as a specific sub-group within ASEAN. It is recommended that much more should be done to integrate these countries into ASEAN as a whole, while recognising that some initiatives are already underway, such as the Initiative on ASEAN Integration and Narrowing the Development Gap.

4 Modern Global Value Chains

Governments in developing economies sometimes express concerns about how to move up GVCs. Taking on more productive roles, further up the value chain, is the key to gaining the rewards of higher growth rates, higher productivity and greater learning. Value added is higher in upstream and downstream services activities, such as R&D and innovation, logistics, and marketing. It is lower in midstream manufacturing processes centred on assembly. Firms therefore have a clear interest in increasing their participation in services in order to achieve higher value-added sales.

Initial access to participation in a value chain is the first step, followed by assessing how to capture value *within* that chain and climb it. Economies such as Cambodia, Laos, Myanmar, and Vietnam, should consider how to initially attract low value-added jobs and subsequently move up the value-added ladder, as they become more integrated and confident of working with global and regional clients.

ASEAN Member States have already benefited from GVC integration. Initially, countries in the region were predominantly involved in midstream, low value-added production. These included textiles and electronics, and services incidental to goods production, such as maritime transport, logistics and financial services. However, over time the region's integration into GVCs facilitated knowledge diffusion and learning, as firms located in AMS were able to access leading-edge technology and best-practice management approaches, creating new opportunities and pressures and incentives for them to upgrade their technological and management capabilities and skill levels of their workers (Ernst and Kim, 2001).

In order to fully exploit opportunities, it is necessary to identify specific choke points preventing access to value chains and requiring policy attention, from which possible options for moving up value chains are identified. In 2011 the APEC Business Advisory Council submitted to APEC Leaders an integrated mapping for both goods and services supply chains, which also identified relevant policy issues to relieving choke points along the chains in both goods and services sectors.

For trade in intermediates to thrive, it is vitally important to continue the process of relieving choke points and reducing trade costs. Global value chains can only operate efficiently if the business and trade environment they face enable them to do so. Despite the huge reductions over recent decades, which have generated GVC activity, a recent study by the World Bank has shown that the absolute level of trade costs can add more than 100% to costs of manufactured goods-exports and over 200% on average to the costs of agricultural goods-exports (Arvis et al., 2013).

4.1 Specific costs relating to ASEAN countries and suggested preliminary solutions

Efficient and reliable transportation and distribution are essential in GVCs to facilitate the movement of both inputs and outputs across borders, at low cost, and with as little risk as possible (Arvis et al., 2013).

Logistics, combined with fast and reliable telecommunications and efficient border control operations and facilities, help enable and contribute to global supply chain performances. Firms in countries with inefficient logistics and related infrastructure will struggle to participate in such networks. Indeed, according to the World Bank's "Enabling Trade" report in 2013, logistics barriers impede global trade flows much more than tariffs do, and reducing supply chain barriers could increase world GDP six times more than if all tariffs were removed.

To participate in service GVC activity, businesses must move people and data. Businesses need to be able to obtain visas and ensure the movement of employees is easy and uncomplicated. This is necessary to gain access to markets and necessary skills, to attract the necessary staff that can carry out knowledge-intensive work, to deliver services to customers and deliver other high quality service activity. Meanwhile, companies need free movement of data as part of their business offers and as part of internal processes. Developing countries should ensure that they address any restrictions in the movement of services, people and data in order to make them competitive and to enable participation in GVCs.

Related to the free movement of data, the connectivity and compatibility of technical and professional services standards, including efforts towards mutual recognition, is also necessary in improving the efficacy of supply chain management. Any disconnect at a technical level will badly disrupt the ready functioning of GVCs by making it difficult for international firms to collaborate and work together.

Constraints on inward foreign direct investment can also hinder potential GVC activity in developing countries, as the absence of foreign investment trade partners means that trade financing needs often go unmet. Some estimates put the global gap in unmet trade financing needs as high as US$1.6 trillion, US$425 billion of which is in developing Asia (Beck et al., 2013). This underscores the importance for developing countries to fast track FDI processes, including policies such as the establishment of Export Processing Zones (EPZs). In 1995, 73 countries had 500 EPZs, reflecting the rise of GVCs; by 2006 this had grown to 3,500 EPZs in 130 countries (Milberg, 2007).

Given how important efficient service inputs are (both domestic and imported) for effective participation of local SMEs in GVCs, it is important to focus on the relatively high levels of protection which persist in the services sectors, and which in some countries, in some sectors, continue to increase. Such barriers increase operating costs and capital expenditures, and create and exacerbate delays faced by businesses.

4.2 Insights from ASEAN Country Studies

ASEAN presents an interesting and unique study in terms of evaluating its Member States' roles in GVCs. The substantial differences in its economic and political environments means that each country has its

own specific constraints and challenges to maximize the potential gains from accessing and moving up value chains. Most of the ASEAN countries still have room for improvement with respect to moving up GVCs, albeit some more than others.

4.2.1 Transport and distribution

In terms of transport and distribution, countries such as Singapore, Malaysia and Thailand have excellent infrastructure; home to some of the world's busiest ports (e.g. Singapore Port, Port Klang, Laem Chabang) and international airports (Changi, KLIA, and Survanabhumi international airports). In addition, these countries understand the importance of ensuring that these transport hubs have substantial capacities to facilitate trade flows in and out of the country. Singapore is planning to invest US$8billion to double its container port capacity in a move to stimulate economic revival in the country by better competing with neighbouring ports and to cope with congestion in the area (Ship Technology, 2013). Significant steps have been taken to improve the infrastructure of Malaysia's Port Klang, which is the 13th busiest port in the world, through better financial management. (World Shipping Council, 2015). This complements its impressive network of connectivity between the port with Kuala Lumpur and Putrajaya, as well as the Port Klang Free Zone.

These transport and distribution hubs, which facilitate the flow of imports and exports from other countries, have facilitated industries in these countries to move up the value chain and exploit any competitive advantage they may have. Recognizing this, these countries have continued to invest in maintaining and maximising the advantages these connection points provide.

Myanmar and Lao PDR have poor quality transport infrastructure. In Myanmar, the inadequate road network means that products must still be shipped by sea, even to border markets. Road density, for example, is about 2km per 1,000 people against an ASEAN average of 11km per 1,000 (ADB, 2012). Addressing such issues may be difficult as transport planning is particularly complex and fragmented in Myanmar, with transport-related issues managed by six ministries and several city development committees. Along with customs and border procedure difficulties these factors contributed to place Myanmar 145th out of 158 in the World Bank's Logistics Performance Index (LPI) in 2014 (Arvis et al., 2014).

More promisingly, Lao PDR has made significant recent progress through customs automation and trade facilitation reform, reducing the cost and time associated with clearing cargo at the border, especially for major exports and their imported inputs. However, as Laos is landlocked and has no major railway routes, trade out of the country relies on roads, and Laos has some of the highest fuel costs in Asia. Furthermore, the roads that do exist are often unable to withstand heavy international-standard trucks. This adds to the costs that GVC participants face, and is further exacerbated by delays to the Greater Mekong Sub-region Cross-Border Transit Agreements (CBTA). The CBTA is an ADB-financed project, which will cover cross-border transport facilitation (including single-stop and single-window customs inspection systems, movement of persons and transit traffic regimes) and facilitate the transportation of goods quickly over land to other major production and consumption locations.

4.2.2 Cross border trading costs

The efficiency of new physical infrastructure to promote trade, including ports, roads, airports and other similar regional trade-enhancing projects, is enhanced if the complementary border controls and customs allow sufficiently free cross-border movements of goods and services.

One example can be seen in the Asian Development Bank's Great Mekong Subregion: East-West Corridor Project, an all-weather road connecting Mawlamyiang in Myanmar to Danang in Vietnam, aimed at expanding the market for transit and bilateral aid amongst the countries through which the road would pass (ADB, 2008).

According to the World Bank's "Doing Business 2015" indicator for *ease of trading across borders*, ASEAN countries have widespread and varied performances. Singapore (1st) and Malaysia (11th), both require few documents to import and export and have some of the lowest costs in the world with respect to the procedures required to import and export goods. Meanwhile, Myanmar (103th), Cambodia (124th), and Lao PDR (156st) all score poorly, let down by the costs of importing and exporting[8]. Countries such as The Philippines (65nd), Indonesia (62th), and Vietnam (75th) all scored similarly across the indicators.

Whilst the Indonesian Government's development strategy framework (MP3EI) emphasizes investments in hard infrastructure, Indonesia's enhanced participation in global value chains will also depend on the country's ability to provide the necessary "soft" infrastructure - improving the operational efficiency of the national logistics system. For firms participating in GVCs that demand the timely sourcing and delivery of components, such as in the textiles and automotive sectors, an efficient logistics environment is crucial to their success. As a result, the recent implementation of 24-hour port operations, and the Indonesian National Single Window (INSW) for border clearances, are good steps forward by the Government.

4.2.3 Openness to foreign investment

A country's integration in the global economy is now more accurately represented by its participation in GVCs than by traditional trade measures of exports and imports. Increasing the amount of foreign investment in a country is paramount for accessing GVCs and moving up the value-chains.

In our analysis of Indonesia's GVC Readiness Index, Indonesia performs well in terms of cost competitiveness, as well as in trading costs including in the tariffs sub-category. Indonesia has been able to import the machinery and knowledge to help maximize and facilitate its certain sectors moving up value-chains, such as the automotive and electronics industries and various other service sectors.

The heterogeneous mix of AMS makes it difficult to interpret summary ASEAN data and indicators. The diversity pertaining to development suggests the importance of analysing each country individually rather than only as part of a group, or at least separating the CLMV from the rest. The same challenge

[8] According to the World Bank's "Doing Business" indicators, these procedures analyse the duration and cost of documents preparation, customs clearance and technical control, ports and terminal handling, and inland transportation and handling.

arises when deriving policy recommendations for GVC integration and outsourcing. The most important factors and conditions for such integration are specific to the level of development and technological sophistication. Naturally, this implies that differences between countries within the ASEAN-6 or CLMV prevail.

Nevertheless, the following section of the Policy Paper attempts to present a set of specific proposals for actions at the ASEAN level. The recommendations stem from the insights obtained through quantitative and qualitative research conducted in preparation for the Regional Report, as well as other secondary literature – including recent work in APEC. In all sectors of the economy attracting leading foreign firms to purchase outsourced intermediates from local AMS suppliers is about ensuring the competitiveness of AMS firms. This is highly dependent on the local regulatory environment including national and regional connectedness with international markets. The Study finds that attracting local and foreign financing to support AMS inputs to global value chain activity is important. In light of this, the recommendations focus on ensuring the coherence and efficiency of domestic regulatory regimes and on public/private dialogue with stakeholders in the conduct of any regulatory reform process. Although much of this has already been addressed in some of these areas, it is useful to present a comprehensive list of the key actions that could best support outsourcing, trade and investment.

5 ASEAN Strategic Positioning and Policy Orientations post 2015

5.1 GVC related factors affecting ASEAN positioning

The Regional Report, on which this Policy Paper is based, traced the last two decades of global and regional evolution of GVCs. In a nutshell, the East Asian region has been among the most dynamic: Japan was the first regional hub until by 1995, the increased fragmentation of regional production networks enabled the United States to enter the picture, importing Japanese goods via Singapore and Malaysia. Within ten years, the centre of the production network had completely shifted to China, pushing the United States and Japan to the periphery. China became the core assembly point of “factory Asia” and supply chains into China became increasingly sophisticated, incorporating substantial amounts of intermediate value added from every regional supplier country involved including most of the AMS. The competitiveness of Chinese exports became attributable not only to cheap local labour but also to the sophisticated intermediate inputs coming in from other East Asian economies, even if the final product ended up labelled “Made in China”.

These dynamics continue to play themselves out. ASEAN has always been and remains an important alternative to China as an outsourcing destination and ensuring competitiveness both vis-a-vis China as well as in the Chinese B2B market, remain key to ASEAN’s overall strategic positioning. New factors are also entering the picture as China’s growing middle class becomes a huge new regional growth market in its own right.

China will continue to see a rapid expansion in domestic demand, and trade with China is of great significance to future growth of the economies of ASEAN Member States. ASEAN’s total population is

less than half of China's and its average per capita income is just over one-third of China's: the ASEAN market is therefore one-sixth the size of China's. In 2012, China had a (PPP) per capita income of US$9,033, Thailand had slightly higher, and of course Malaysia, Brunei and Singapore much higher per capita incomes. The other six AMS had lower per capita incomes (and most of the ASEAN population), and these countries are attractive cost competitive destinations for Chinese firms to outsource, and for international firms looking to move out or diversify from China.

Against this background, intensified economic integration across the AMS can be seen as the key to delivering increased ASEAN efficiency and hence attractiveness to outsourcing activities designed to exploit ASEAN's proximity to large emerging regional markets. Accelerated implementation of the AEC should mean ASEN can offer China, India, the United States, the European Union, Japan and others the opportunity to source in one region "the full package" of goods and services across the whole value-added spectrum.

In its own right, the size and proximity of China as a trading partner presents a significant opportunity for economic development in ASEAN; by exploiting cultural similarities, time zone advantages, and the mix of high and low-end services and goods that a more integrated AEC could deliver. ASEAN is well positioned to supply an increasing range of both goods and services, across a very wide variety of industry value chains, including in services such as education and tourism.

Another key strategic factor is the role being played by ASEAN in the emerging regional architecture of trade and investment governance.

The greater recent momentum towards AEC has significantly intensified the negotiations sometimes referred to ASEAN +6, or the Regional Comprehensive Economic Partnership (RCEP). This will create the world's largest free trade bloc, given that it would account for around half of the world's population and 40% of global trade. Amongst the participants are some of the world's most as well as least open economies, and while ASEAN already has an FTA with each of the other 6 RCEP Parties, some have not had an FTA with one another.

The negotiations have been taking place simultaneously with those for a Trans-Pacific Partnership (TPP). The TPP negotiating agenda is ambitious, as it seeks to tackle a broad range of issues including for example intellectual property rights, competition policy, e-commerce, environmental and labour issues. Importantly from a GVC participation perspective, there is a greater attempt to influence behind the border regulatory practices, recognizing the new trade imperatives.

RCEP is an ASEAN-led model, including China and excluding the United States. TPP is a more NAFTA-styled model including the United States and excluding China. But both models constitute viable means of joining the dots among the many bilateral FTAs in the region and consequently stimulating wider regional economic growth. And despite their differences, the emphasis in both these sets of mega-regional negotiations has evidently shifted from pure market access to greater market integration, more reflective of an interconnected production system.

How the AEC will interact with these two different pathways to wider regional integration will be a key ASEAN trade and investment policy matter for the post 2015 period ahead. The joint agenda will be further influenced by discussions now formally underway in APEC after APEC Leaders adopted in 2014 the pursuit of the Free Trade Agreement of the Asia Pacific (FTAAP) as a core regional priority. Integration efforts underway in APEC's Western Hemisphere, where Latin American economies[9] have recently concluded the Pacific Alliance (PA), will also have a bearing on the pathway to FTAAP.

One thing that is clear is that all of these 21st century mega-regionals will necessarily have to go beyond the traditional trade agenda to take greater account of how businesses, especially SMEs, need to operate in a world where production of both goods and services is increasing fragmented across borders into global and regional value chains.

In most global and regional trade policy fora, commentators are increasingly calling[10] for versions of GVC-oriented trade agreements, whether these be agreements designed to take better account of the role of services in manufacturing, or agreements driven by the importance of investment in outsourcing activities, or agreements that focus behind the border on the enabling regulatory environment, or agreements that dedicate more attention to economic cooperation to remove GVC chokepoints and blockages, enhancing interoperability and facilitating people movement. The outcome is inevitable. There can be no doubt that 21st century trade and investment governance will ultimately become much more GVC driven. This is likely to be reflected early in ambitious outcomes of TPP, in new directions taken in RCEP and in the blue sky thinking now underway on FTAAP, especially in the APEC Business Advisory Council (ABAC) and the Pacific Economic Cooperation Council (PECC).

Against this backdrop, the extent and pace to which the AMS achieve progress towards the goals set out in the AEC will naturally impact on the degree of ASEAN participation in the outsourcing and GVC phenomenon, and will be critical to the success of continued efforts in achieving internationalisation of ASEAN industries.

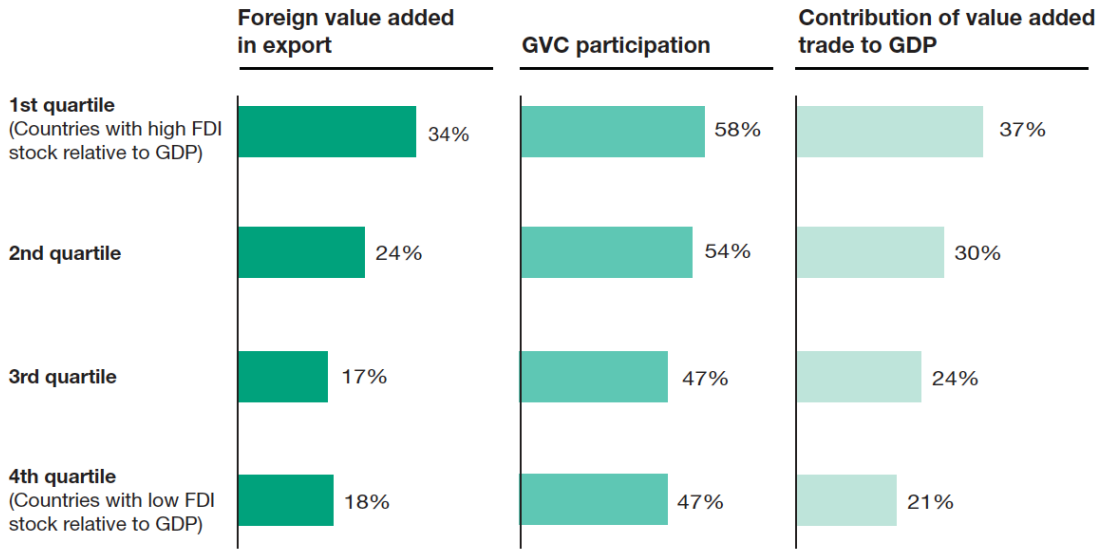
Over time ASEAN will need to strategically position itself in order to compete for the on-shoring of higher value-added tasks in both goods and services. New opportunities continue to open up as global businesses focus more and more on their core competencies and outsource all other peripheral tasks in an effort to reduce costs and to shift to higher value-added activities. But competition from outside the region is strong and growing, especially in China, South Asia, and also Africa. There is an urgent need in ASEAN to better understand and take more seriously the business opportunities available and the means to access them. It is vital for ASEAN to position itself strategically to take advantage of new opportunities in global and regional outsourcing.

It is important to be aware for example that a global evidence base is now accumulating to show the benefits of GVC participation. TiVA data has been used, for example, to estimate the number of jobs sustained by final foreign demand. One study by the OECD showed that the greater the participation in

[9] The members of the Pacific Alliance (PA) are Chile, Peru, Colombia and Mexico.
[10] For example Nakatomi (2013), Baldwin (2013)

GVCs, the higher the percentage of employment accounted for by final foreign demand. Final foreign demand accounted for 16% of employment for Indonesia in 2008, 17% for Russia, 19% for India, 22% for China, 24% for Korea and 36% for Chinese Taipei. Brazil, as a counter-factual, had only 9% of its total labour force sustained by foreign demand.

Figure 5.1: Value-added trade indicators, by quartile of inward FDI stock relative to GDP, 2010



Source: Zhan (2013)

Figure 5.1 shows the results of UNCTAD work which identifies a positive relationship between inward FDI, foreign value-added in exports, GVC participation and the overall contribution that trade makes to GDP. These are important policy relevant finding, highlighting the importance of investment flows for trade and growth outcomes. Given the globalized nature of production, investment and trade in the 21st-century, governments must continually ask themselves what kind of policies facilitate or inhibit participation in GVCs, especially for SMEs. The cost of protectionist measures imposed in a globalized context can be higher than originally anticipated because of the impacts on intermediate components of production can accumulate and magnify the impact on the final goods or services themselves. For firms of all sizes but especially SMEs participating in GVCs and trying to remain competitive, lower barriers for imports have become nearly as important as access to export markets.

5.2 Recommended Policy Orientations post 2015

This Policy Paper has revealed how analysis and measurement of the outsourcing and GVC phenomenon helps to reframe policy issues relevant to ASEAN's international competitiveness. The next question, however, is whether analysis of outsourcing, including use of the new statistical database on trade in value added as well as results of stakeholder perception surveys employed in this Study, do or do not suggest different policy orientations for ASEAN from those arising through the traditional trade policy lens.

Some commentators suggest that the main implications of GVCs have chiefly to do with domestic policy settings such as industrial policy, rather than international policies.[11] But the analysis in this report, which is geared specifically to achievement for ASEAN of regional integration objectives, with ASEAN operating as a central hub within the wider Asian region, provides quite clearly, a number of important policy insights on both the domestic and the international front.

First and foremost, the analysis highlights the overwhelming importance of the trade-investment nexus and the importance for outsourcing of flows of FDI. Every aspect of investment policy has implications for trade policy and investment regimes become far more important than before in considerations of "connectivity". The current global flurry of international negotiation of bilateral investment treaties is testimony to this reality.

Second, as investment in outsourcing activities are seen to be relatively footloose and to respond to shifts in competitive advantage, the extent to which domestic institutions are transparent and regulatory settings are enabling of business become prime considerations in investor decision making.

Third, innovation policy moves closer towards centre-stage as the knowledge-intensity of business activity is increasingly identified as central to domestic value addition and to climbing the value added ladder.

Fourth, the factors driving competitiveness in services come into major policy focus because they are more clearly understood as impacting on all other sectors of the economy, with efficiency in services activities becoming make or break for competitiveness in other sectors.

Fifth, infrastructure is as important as ever, but the emphasis shifts to encompass the knowledge economy, especially digital infrastructure such as broadband internet and human capital especially education to develop the local talent pool.

Pulling all this together, regional policy and regulatory dialogue and regional capacity building efforts need to intensify in all the above directions. And quickly, as the deadline for the AEC looms large and the post 2015 agenda starts to take shape.

Against this background, there is an evident need for the AMS to take a more holistic and more cooperative approach to trade, investment and industry policies, in the interests of overall ASEAN competitiveness and closer regional integration. In a globalised world where trade is no longer only about goods but also about services and other less tangible products, such as ideas and data, trade policy needs to be seen as part of a broader package of policies and regulations with, among others, investment and innovation. This chapter sets out a number of specific recommendations oriented to building on ASEAN's already strong performance in GVCs to ensure continued growth opportunities as a regional hub for outsourcing (Country-specific recommendations are listed in Appendix 2)

[11] See Stephenson (2013) "Global Value Chains: The New Reality of International Trade"; Low and Tijaja (2013) "Global Value Chains and Industrial Policies"

More than ever, national economies are complex adaptive systems, where any change has multiple consequences. Thinking in terms of policy silos should be avoided, particularly with respect to policies with an international dimension. The implication for ASEAN is that GVC readiness should be the new trade and investment policy framework. Its numerous variables are all inter-connected and any proposed changes must be evaluated in that context.

In a world of fragmented value chains and digital technology, it is making much more sense to look at country and regional efficiency, or more precisely productivity, as a whole, holistically. This means addressing the full gamut of policies that impact GVC readiness and global competitiveness, including within borders and in supporting services.

A GVC relevant policy reform agenda, which encompasses policies to promote outsourcing, must take into consideration the vast array of variables that determine country competitiveness. There are very few variables we might identify as outsourcing-specific, as all the variables that determine competitiveness generally, also influence outsourcing attractiveness. Some variables are more important for outsourcing (e.g. economic zones, English-language skills, etc.), but all domestic and border variables that influence competitiveness are also relevant to outsourcing. Consequently, the policy horizon must shift and broaden to take into account a larger set of inter-related policies. Outsourcing policies include, for example, investment in education and skills of all kinds, financing of infrastructure, provision of trade finance, facilitation of R&D and innovation systems to encourage industry-university collaboration and related efforts to attract foreign investment partners.

Trade and investment policies can have unintended and counterproductive reciprocal effects if not considered in the whole context of GVCs and competitiveness (Zhan, 2013). To avoid this, “policymakers – where necessary, with the help of international organisations – should carefully review those policy instruments that simultaneously affect investment and trade in GVCs; i.e. trade measures affecting investment and investment measures affecting trade” (Zhan, 2013). At the institutional level, at the minimum, this implies closer coordination and collaboration between trade and investment promotion agencies.

While the diversity of AMS economies naturally makes it difficult to draw firm conclusions for ASEAN as a whole from summaries or regional indicators, the biggest deterrents to increased outsourcing to ASEAN identified in this report include: inadequate infrastructure; insufficient connectivity at the border; inefficient regulatory regimes; under developed services competitiveness and capacity, insufficient attention to education, human capital and skills mobility.

Infrastructure

Telecommunications and transport infrastructure needs to be enhanced. ASEAN should redesign and reinvigorate its program to reduce logistics barriers to trade, especially clearance processes at customs, transport, infrastructure. ASEAN should also consider creating an agency or an inter-ministerial committee that focuses on logistics performance, linked to a working group that incorporates the private sector into these discussions.

More national investment should be made to boost internet access and penetration and fast reliable broadband. Digital infrastructure must also be of world quality, which can be achieved more easily perhaps than other forms of infrastructure.

Connectivity at the Border

The most important barriers at the border are associated with restrictions on inward FDI such as foreign equity limits or restrictions on nationality or residency of Boards of Directors and restrictions on visas and absence of recognition of professional qualifications.

Market access barriers also exist behind-the-border, such as licensing arrangements, which affect foreign firms' scope of business. Behind the border domestic regulations and efficiency of government agencies with services sector oversight have more significant impact on trade in services than is the case in other sectors.

Opening up investment regimes enhances market access by removing or reducing the costs of quota schemes, licensing arrangements, tariffs, localisation requirements, and rules of origin regulations.

Technical regulations, standards and conformity assessment procedures, sanitary and phyto-sanitary measures all impose costs upon business, for well accepted public policy reasons of personal and environmental safety, but need to be carefully monitored to minimise unnecessary costs on businesses.

Effective border administration can be enhanced by removing or reducing the costs of customs administration, import-export procedures, and the transparency of border administration, including by moving to paperless procedures and adopting a single window. Ideally this would include better coordination between border agencies and reducing the administrative burden of complying with standards. In particular, emphasis should be placed on removing country-and-product-specific import rules, which are sometimes consciously applied as a barrier to trade.

Regulatory Regimes

The business environment can be enhanced by making the regulatory environment more transparent, simpler, less risky, less duplicative and less burdensome for business and by reducing the costs of making investments, hiring foreign and local workers, locating access to finance, and achieving physical security. These actions are intimately connected to increasing the efficiency of the services sector.

Given its percentage of total GDP and employment (and share in value added terms in gross exports), services have until very recently not been receiving adequate attention in trade negotiations. Further, most service provisions focus on market access barriers, while few focus on behind the border issues. In relative terms, there are far fewer trade outcomes achieved for ASEAN services industries compared to goods. This presents ASEAN with an opportunity to seek higher levels of commitments from member economies, as well as from other trading partners, to move forward in a collective and inclusive way by realising the opportunities of creating a region wide trade in services framework.

There is a wide range of issues for a services framework to address. Domestic services sector regulations, industry standards, and professional requirements act as barriers to trade in services. Economy-specific regulations discriminate against foreign services providers by either raising transaction costs or by requiring domestic presence. Further, differences in service sector regulations across economies raises transaction costs for firms seeking to export to multiple markets. This is a disproportionally larger problem for SMEs and services firms in developing economies, which seek greater regulatory convergence.

Factors inhibiting competitiveness in trade in services include: disconnects in standards and specifications, burdensome domestic regulation, lack of regulatory transparency, consistency or stability, inconsistent monitoring and enforcement, poor coordination among government agencies, differences in language and culture across destination markets, access to human capital especially skilled talent.

Services Competitiveness and Capacity

Given the major role of services in adding value to exports from all sectors of the economy, there needs to be more focussed attention to ASEAN-wide competitiveness in services. This will help promote increased ASEAN participation specifically in global cross-border services value chains and ensure the infrastructure and talent pool of appropriate skills sets exist to enable climbing the ladder to higher value added work in global goods value chains.

Individual AMS should be encouraged to consider creating a whole-of-services coordinating body responsible for services sector growth, including the articulation of national competitiveness strategies for services and formation of appropriate stakeholder consultation mechanisms. This body would liaise with various otherwise uncoordinated government agencies and departments to identify competitiveness strengths and weaknesses (and contradictory policies) to be addressed, including at the regulatory level.

Education, Human Capital and Skills mobility

Access to human capital and skilled talent impacts firms at all levels. Access to the largest pool of talented employees is essential to encourage businesses to develop and innovate, and stimulate economic growth in general. A lack of domestic human capital can be mitigated in creative cross-border supply chains, which open up access to foreign talent.

Tailoring the education system to create the talent pipeline for emerging industries should be encouraged, including promoting apprenticeships, developing public-private partnerships to promote training and education, or providing grants to encourage particular industries. Strategic skills planning should be used to assess current and anticipate future skills shortages.

Wider availability and access to loans and grants for continuing tertiary education would encourage more people to study and increase their employability and skills-set.

Greater cultural, educational, and linguistic ties for future generations can also be encouraged through exchange programmes for students. By undertaking some of their studies in another country, students learn and understand cultural norms and differences, which can eventually help employers conduct business across borders. Consideration could be given in ASEAN to the conversion of study visas into limited work visas following graduation.

Talent, ideas and information are integral to services competitiveness. In the context of this imperative, much greater priority should be given to education and training generally, not only higher education but also language and vocational training. Greater attention could be given to establish ASEAN regional educational, cultural and research exchanges. Language and cultural barriers are a continuing issue in the modern business environment and can potentially present stumbling blocks to future cooperation.

Faster progress needs to be achieved in implementation of the ASEAN MRAs in the professions. Beyond the professions, policies are needed to facilitate more general intra-ASEAN people mobility.

5.3 The role for proactive industry policies

Industry policies can play an important role, but they can also be expensive and have many unintended consequences if implemented poorly, or when supporting narrow vested interests. Industry policy is most effective in enhancing GVC activity when explicitly focused on people: on encouraging innovation, know-how (tacit knowledge) and intellectual property and the ongoing implicit transfer of technology through FDI. This people-dynamic is, of course, strengthened by investments in infrastructure, ICT, and governance institutions; while also moving towards implemented international norms in regulations, standards, etc.

In considering industry policies, it is vital that countries understand the full extent, downstream and upstream, of the GVCs that are critical to their economy. This knowledge is needed to identify what is most important to their operations on the GVC, and then design policies to foster innovation in order to move up value chains. Consultation with the sector and industry experts is critical, while at the same time avoiding being captured by vested interests. That risk may be minimised by a broad stakeholder representation during policy consultation.

Industry policies play a positive role when they are designed on the basis of (current and potential) comparative advantage, prioritise the removal of distortions, promote competition, and support investment in infrastructure and education, provision of trade intelligence, and export financing mechanisms for SMEs. Some commentators call for comparative advantage "defiance" (Reinert, 2007; Milberg and Winkler, 2013), and attempting to support sectors or companies to succeed. The focus of the State should not be on particular firms or goods and services, but rather on the general environment that supports businesses, and in particular innovation and risk-taking.

Industry policy should also include consideration of free trade zones for both goods and services[12]. Export Processing Zones (EPZs) have become significant GVC hubs for goods by offering benefits to trans-national corporations and suppliers in GVCs. Similar policies are now being experimented with for

services. Policymakers are increasingly setting up relevant supporting physical and digital infrastructure, including technical assistance for certification and reporting, support on occupational safety and health issues, education and training, incubation for innovation, financing and recycling or alternative energy facilities, transforming EPZs into centres of excellence for sustainable business. International organisations can help through the establishment of benchmarks, exchanges of best practices and capacity-building programmes.

ASEAN could be proactive by agreements to promote particular AMS as regional hubs for particular activities. In a world of growing regional value chains, regional cooperation becomes more important and forms of "Regional industrial development compacts" (UNCTAD 2013 *World Investment Report)* can be developed. Regional industrial development compacts could encompass integrated regional trade and investment agreements focusing on liberalisation and facilitation, and establishing joint trade and investment promotion mechanisms and institutions.

They could also aim to create cross-border industrial clusters through joint financing for GVC-enabling infrastructure and joint productive capacity-building. Much of this is already being done in ASEAN, but to be truly effective this approach needs to be fully embraced such that conformity to ASEAN-wide policies is given greater emphasis – with fewer delays and exceptions.

Five areas need priority: firstly, a general high-level reinvigoration of the AEC vision to spur faster and deeper implementation; secondly, a focus on the services sector; thirdly, higher priority to achieving progress in strengthening human capital; and finally, broader and more systematic dialogue processes that involve all AEC stakeholders. ASEAN governments also need to encourage investments in intangible assets (copyright, business methodologies, brands, etc.), as part of an overall effort to promote innovation and R&D.

Progress in these areas is crucial to fully achieving the AEC vision by 2020, and thereby integrate AMS as more competitive players in GVCs and in outsourcing.

There needs to be a major visible high-level boost given to set new, clear and ambitious targets on every front to fully implement the AEC by 2020. Targets should be measureable and transparent, and achievable. This new phase of reforms may be characterised as behind the border, as much has already been achieved with at the border policies, particularly tariff reductions. The policy vision should be holistic: to allow freer movement of goods and services and capital and people, by reducing restrictions both at the border and behind-the-border and making a greater effort to adopt international standards and achieve mutual recognition of them.

ASEAN should consider establishment of a formal mechanism, at senior level, through which the AMS can raise instances where a blockage along a specific GVC is identified as preventing completion of the production chain or withholding opportunities for greater regional value addition.

Institutionalise broad dialogue and quality research for GVC Readiness

There needs to be greater business stakeholder participation, ASEAN wide, in drawing up an ASEAN roadmap to boost GVC Readiness. A key objective is to help each AMS get its domestic regulatory house in order.

Regulatory transparency and predictability are essential conditions for firms to make long-term FDI investments. Opaqueness in regulation makes conducting business much more difficult, and undermines confidence in and credibility of a country's economy. Inconsistent regulations are often unintentional but increase the costs incurred by businesses, potentially driving them to relocate to other regions. It is extremely important that there be a high degree of coordination across government agencies and departments. There are different ways of achieving these objectives, nationally and ASEAN-wide.

ASEAN could facilitate within Chambers of Commerce and Industry (CCI)/Singapore Institute of Directors (SID) and/or the ASEAN Business Council, the creation of a new forum to bring different business associations from the AMS together to foster a region-wide GVC Readiness Business Dialogue and/or regional outsourcing forum. This kind of stakeholder engagement could promote the sharing of intelligence on business strategies, the regulatory environment, labour movements, investment flows, standards, qualifications and skill-sets. A working example of such a forum would be the International Outsourcing Forum aiming to set a "platform for senior executives working in specific areas of the outsourcing sector to meet, share experiences, raise issues and find solutions with their peers and business partners" (International Outsourcing Forum, 2013).

It would also be useful to engage academic stakeholders in a similar process. ASEC could support the SID and, or Business Council secretariat with a research programme about GVCs, while also consolidating and funding analysis based on feedback from business groups on identified regulatory inefficiencies and barriers to connectedness. This reporting could be distributed to foster an ongoing national and collaborative regional research agenda to map GVC chokepoints (e.g. via surveys or statistical analysis). National research processes should be intensified to measure the costs of regulatory disconnects and collect the evidence base for reform. This research would also analyse best practice models and test methodologies for regulatory review processes.

To support and measure ASEAN participation in global and regional outsourcing activities in both goods and services, one option would be a high profile ***Competitiveness Report Card or GVC Readiness Report Card***, for each AMS and for ASEAN as a whole, that is calculated annually and publicly reviewed. This document could be based on the index created for ASEAN in this report. It would benchmark ASEAN to the rest of the world, and be tabled for discussion at high-level meetings. The above initiative would serve not only to measure ASEAN progress in this fundamental area of trade but it would also quickly improve the accountability and transparency of the effort to move towards an AEC.

In all the above processes, a more dedicated concerted use of APEC-OECD's "Integrated Checklist on Regulatory Reform" would be of value. This is a soft self-assessment tool, which is simple yet comprehensive and could be used to guide the process of increasing regulatory certainty and credibility

across the AMS. Another associated tool is the World Bank's Services Regulatory Assessment Tool Kit, released in May 2014.

It is also important in development of any regulatory reform strategy to ensure that proposed reforms undergo thorough independent analysis in terms of their costs and benefits from the perspective of productivity and competitiveness. Transparency of process is important as it boosts business confidence, and projects a favourable image to potential foreign investors, both key ingredients in building GVC participation. The Australian Productivity Commission could be of assistance in this regard. They could assist in developing and testing ASEAN-relevant regulatory review processes and similar policy analysis tools.

Consolidated business feedback on impediments to trade and investment and the costs of regulatory inefficiencies, linked to an independent research effort and information transparency, would provide a strong basis for promoting an ASEAN-wide focus on the importance of transparent and efficient domestic regulation.

To combat incoherence, inconsistency and instability in regulatory regimes impacting on cross-border business and GVC connectedness, policy-makers need to come together not only with the business community but also with the regulators, to share best practice experiences, discuss ways of easing the burden on industry and to pilot coordinated programmes across ASEAN. There would also be benefit from evidence-based research findings and well-evaluated policy experiments.

These various strands could be facilitated by the establishment, perhaps under the Investment Committee, of an ASEAN GVC Participation Taskforce. The broad policy scope of GVCs presents a new governance challenge: in an increasingly inter-connected world, breaking policy into discrete areas (FDI, competition, industrial, border trade policies, etc.) is becoming less meaningful. A holistic approach to policy is needed; one that acknowledges the connections and repercussions of changes across the whole economy (as a complex adaptive system). A higher-level Taskforce may be needed to ensure coordination and consistency across the "silo" policy groups.

5.4 Concluding Comment

The ASEAN Economic Community is the flagship for regional integration in ASEAN since its launch in 2003. Since then there has been considerable progress in many areas, notably the reduction of tariff rates, and the latest (2012) AEC Scorecard reported about two-thirds of commitments had been achieved across the ASEAN Member States. Nevertheless, by the target date of 31 December 2015, much will remain to be done to fully achieve the overall goal "to establish a single market and production base, characterised by the free movement of goods, services, investment, and a freer flow of capital" (ASEAN, 2014).

This Policy Paper has underscored the need for further progress within the AEC framework, and as the recommendations above indicate, there is an important role for pro-active leadership by Governments to achieve the AEC objectives. The global economy has changed radically since 2003: global value chains have continued to expand, along with related outsourcing activities; the growth rates of international trade, investment, and outsourcing - particularly in services, continue to exceed domestic GDP growth

rates; and the dynamic costs of country-specific protectionist policies are higher than ever before. In this new global and regional environment, development of efficient regional cooperation and hubs becomes crucial, and there is growing awareness that a silo approach to policy formulation must be replaced by a broad holistic approach that focuses on overall productivity and competitiveness. In other words, fully implementing the ASEAN Economic Community is more important than ever before.

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